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March 8, 2000

The Honorable Tom Bliley
Chairman
Committee on Commerce
United States House of Representatives
Room 2125, Rayburn House Office Building
Washington, DC 20515-6115

Dear Chairman Bliley:

Thank you very much for allowing me the opportunity to provide you with input on H.R. 2944. I apologize for replying a little late, but I have, until recently, been traveling out of the country. In any event, I hope that my letter is not too late, and is of value to you and your colleagues as you move ahead in the very important task of building a federal legislative framework for restructuring of the electricity sector.

It is important to note that the reporting of H.R. 2944 out of Subcommittee is a significant event. There is a real need for Congress to address a number of issues related to electricity, and the Subcommittee has done so. Chairman Barton and his colleagues are to be congratulated for the accomplishment. The bill, as it currently reads certainly addresses many critical issues, such as the formation of regional transmission organizations, transmission siting, federal-state jurisdictional boundaries, the future role of federally owned actors in the electricity market, PUHCA, PURPA, consumer protection, and reliability. Some of those issues are dealt with quite well, while others will need to be closely examined as the process moves forward. I hope that you find the comments that follow to be helpful.

Before elaborating, I want to be careful to note that while I am the Executive Director of the Harvard Electricity Policy Group at the Kennedy School of Government, Harvard University, the views which I am expressing are uniquely my own. I make absolutely no claim that I am speaking for the Group, the School, or the University. Indeed, the Harvard Electricity Policy Group never takes a public position on any issue. It is a forum for discussion, reflection, analysis, and debate, but is never an advocate for any particular point of view. Similarly, I am not speaking on behalf of any other entity with which I might be affiliated or have ties.

Let me begin my comments with Section 3. While it is prudent for Congress to defer to the states where possible, a three year prospective "grandfathering" provision seems somewhat problematic from a public policy perspective. Obviously, those states most interested in fostering competition in the sector have already taken steps to implement it. It is understandable why Congress might want to defer to state actions that have already been enacted. By self-definition, however, those states that have not yet acted to restructure, are those least interested in having a competitive electricity industry. While each state ought to be free to make such judgements, if it is the intention of the Congress to promote, as a matter of national policy, competition in electricity markets, it may well be counterproductive to "grandfather" three years of future action in regard to interconnection, aggregation, and net metering by those states least interested in, if not opposed to, competition. I do not see any such concern, however, as it relates to consumer protection in a state with retail competition. In fact, as I will note below, I think deferring to the states on consumer protection is superior to delegating responsibility to the Federal Trade Commission. Moreover, the consumer protection issues only arise when a state opts for retail competition, so each state should be free to address that issue when the need arises.

With regard to the clarification of state authority and federal state jurisdiction, regarding electric service, H.R. 2944, as currently drafted, is of limited value. While I believe it wise of the Congress to defer to the states on whether or not there will be retail competition within the boundaries of any particular state, the distinction drawn between bundled and unbundled transmission service for jurisdictional purposes is problematic. The bill, as drafted, will put an end to the legal controversy over whether states have unbundled retail transmission jurisdiction, an authority most, although not all, states believe they possess. Clarifying the legal issue, however, is of limited value because the jurisdictional distinction between bundled and unbundled transmission perpetuates the very system that makes it extraordinarily difficult to price transmission services in such a way that incentives are coherent and meaningful.

The economic regime within which transmission is priced has remained largely unchanged since the 1920's. With the notable exception of the federally owned electric systems, virtually all transmission assets are owned by utilities subject to state retail regulation. All transmission costs are in retail rate base. The overwhelming bulk of transmission revenues have been derived from retail customers who pay bundled retail rates. Until very recently, not a single state had even seriously contemplated unbundling transmission from other services and sending more discreet price signals. That means that retail customers stand obligated to pay all costs associated with prudent investment in transmission. To the extent that revenues are received from sales of transmission services to "off system" customers, that amount is deducted from the revenue responsibility of retail customers. To the extent that a transmission owning utility eschewed the possibility of deriving "off system" revenues, the retail customers have simply paid more in order to assure that the utility was made whole for its investment. In short, retail ratepayers bore the entire residual revenue responsibility for transmission. For utilities, transmission was simply a zero sum game. Any rewards they might have received for efficient sales of transmission services were given back to retail consumers while

inefficient owners of transmission suffered no financial consequence. All revenue shortfalls were made up by captive retail customers. Significantly, the payments made by customers bore little or no resemblance to the burdens they imposed on the system. Bundled, average cost, rates meant that absolutely no transmission price signals were ever sent to users. For that reason, until recently, it could reasonably be argued that the FERC never seriously attempted, nor had any reason, to do transmission pricing in a way that provided appropriate incentives for investors and sent meaningful price signals to users.

In recent years, the transmission markets have begun to change. The evolution of competition has directed more focus on the critical, bottleneck service of transmission. The FERC has gotten far more serious about transmission pricing. The states, on the other hand, have done very little. The exception, of course, is PJM, where transmission has been unbundled and taken out of retail rate base. While in PJM, retail customers pay unbundled, FERC set, transmission rates, based on an economic model that sends distinct price signals to generators and users alike, in all other states, consumers continue to pay bundled retail rates that contain absolutely no transmission price signals. Despite the fact that Regional Transmission Organizations in the form of ISOs and Transcos have appeared in various parts of the country, that bundled retail rate regime, other than in PJM, has not been altered. For those who advocate transmission incentives, the situation is particularly troublesome, because any incentives the FERC might offer to transmission investors will be taken away by state regulators who will return the benefit of those incentives to retail ratepayers. For competition to work, for there to be appropriate transmission price signals, and for there to be meaningful incentives for investment in transmission, it is imperative that there be a seamless web of transmission pricing, regardless of whether the service is provided to retail or wholesale customers. Thus, the provision in H.R. 2944 which proposes to divide transmission jurisdiction based on whether or not rates are unbundled is counterproductive to the evolution of a meaningful economic framework for transmission. It would be far better public policy to simply unbundle transmission and give the FERC the authority to price all transmission services, or, if Congress wishes for the states to play a role, to create a joint board mechanism to carry out the function.

Three further notes on the issue of federal and state jurisdiction over transmission pricing are worthy of mention. The first is that that states do not need to price retail transmission services in order to preserve monopoly service in the electricity market. If a state does not want a competitive retail electricity market, it does not have to extend its retail jurisdiction to the pricing of transmission services. It would simply incorporate the FERC (or Joint Board) set transmission rates into the bundled rates paid by retail customers, and then the state could do whatever it pleased with regard to the structure of the distribution and energy sales market within the state. The second point is that regardless of whether or not a state unbundles its retail market, transmission services are, by definition, regional, if not inter-regional in scope. Thus, a competitive wholesale market demands an economically rational transmission market regardless of whether or not any given state chooses to have retail competition. It is poor policy to erect a jurisdictional structure that allows a single state's decision to not have retail competition

preclude the development of an economically rational transmission pricing regime. The third point is that some state regulators and others have contended that because their retail customers have borne the residual revenue requirements for all transmission until now, that those customers are entitled to some additional benefits in the form of curtailment priorities or pricing advantages. That priority issue is also implicit in the fact that most, if not all, states, have the authority to establish and enforce service priorities in case of emergencies. The argument is worthy of attention. It might be useful to provide the FERC with the authority to provide some level of discriminatory treatment in order to work out arrangements that address the fact that different classes of customers have had differing levels of exposure to the risks of paying for transmission investment.

Before leaving the question of transmission rates, it is not at all clear to me why there is a need for a provision authorizing negotiated transmission rates. While negotiated rates were often utilized instead of tariff rates for large users in the context of a vertically integrated monopoly, the argument for allowing them in the context of unbundled transmission service may prove to be more problematic than beneficial. It opens up the possibility of undue discrimination, unfair self dealing, cost shifting (which could occur despite the statutory language precluding it), and distorting price signals, without any clear benefit outweighing those potential adverse effects.

One area where H.R. 2944 clearly falls short of the mark is in its exclusive reliance on voluntarism in regard to membership/participation in regional transmission organizations. While voluntarism is fine if it works, the fact is that competition in electricity is entirely dependent on the ability of actors to get their energy to market. Incentives for RTO participation, no matter how cleverly designed, given the institutional barriers enumerated above, may simply prove to be unworkable. Moreover, even were those institutional barriers to be removed, mere voluntarism is still highly problematic. Vertical control of both generating assets and transmission is most problematic. A company that generates power wants to be able to access all potential customers on the most favorable of terms. If that company also controls the only means to get energy to market, namely transmission, there will be an inevitable temptation to afford itself advantages it does not provide to competitors. There are two possible public policy responses to that undesirable possibility. One is a heightened, more intrusive form of regulation in order to preclude impermissible behavior. Given that there are innumerable, often difficult to detect actions that an interested party who controls transmission can take that can dramatically alter the playing field, for competition, the regulatory oversight required to police against abuse will inevitably have to be quite rigorous. The alternative to a very rigorous, intrusive, regulatory regime is structural separation, where operational control over, if not actual ownership of, transmission assets is taken away from entities also engaged in the business of generating electricity. The latter course is attractive, of course, because the operator of the grid is independent and has no interest in the outcome of the competitive market. As a result, there will be less need for regulators to oversee its actions. More importantly, for the market to work most efficiently, each actor should have very clear, unambiguous signals to conduct its business activity in the most effective manner. Cross ownership and control over transmission and generation dilutes, and perhaps, even poisons those signals. As a matter of public policy, it would be most

prudent for the Congress to provide the FERC with clear, unambiguous authority to mandate a jurisdictional company to participate in an independent regional transmission entity. Whether that entity is an ISO, a Transco, or some other form of entity may be an important business consideration for investors but it is a secondary public policy consideration to the compelling need for independence in the operation of the grid. Congress need not, indeed, should not take a position on that matter, but rather leave market participants and regulators to sort out as the market evolves.

In addition to having the authority to mandate participation in an independent RTO, it is critical that both FERC, perhaps, optimally in collaboration with state regulators as well, have authority to mandate the geographic scope of an RTO. The fact is that geographic boundaries of an RTO can be rigged to the advantage of some players over others. Indeed, under the current "voluntary" regime, it is really the incumbent transmission owning entities that define the scope of the geographic market by who they choose to affiliate with or not affiliate with in the operation of the regional grid. Independent generating companies, consumers, economic development officials, and all other relevant and important players are essentially stripped of any say over the definition of the operative regional market. Thus, "voluntarism" under the terms of H.R. 2944 applies only to transmission owners. For all other players in the marketplace, there is no voluntarism. They are required to operate in a framework dictated by a small number of market participants. In Ohio, for example, the regulators have repeatedly raised serious concerns about why the state is being split between two different RTOs. The reason, of course, is quite simple; that is how, for their own business reasons, the incumbent transmission owners have chosen to organize themselves. As a matter of public policy, why should the choices of incumbents dictate results that regulators with responsibility of protecting consumer interests find unacceptable? One reason, some proponents of voluntarism have suggested that such an outcome is acceptable is that the decision of what RTO to participate in is a matter of the disposition of private property, and is, therefore, best left to private investors to decide. While that principle is, in general, a fair one, it loses sight of a very unique aspect of transmission. Most of the right of way that was obtained for transmission facilities was acquired through either the actual or threatened use of the governmental power of eminent domain. Thus, while the financial investment in transmission is private, the ability to have actually have made that investment, and, in fact, the scope of that investment, are the direct result of the exercise of power granted by the government. There is ample precedent in American history for the government to dictate common carriage, and the terms and conditions thereof, when right of way is obtained through the actual or threatened use of eminent domain. In short, the private interest in transmission is satisfied by a pricing regime that affords an investor a reasonable opportunity to recover its costs plus a return commensurate with the risk undertaken. Within that constraint, however, the government has a very legitimate interest in deciding how the right of way is utilized and in maximizing the economic benefits to be derived from its use.

H.R. 2944 takes a very positive step in authorizing regional compacts for the siting of transmission facilities. The step it proposes is long overdue, and the Subcommittee is to be commended for moving in that direction. The only question is

whether the bill goes far enough. While Congress could, of course, preempt the states on the siting of transmission facilities, it seems politically wise and good public policy to provide the states with ample opportunity for meaningful involvement in siting, but not allowing them *carte blanche* to be as parochial as they choose. At present, of course, the siting of transmission facilities is almost exclusively a state function. With very limited exceptions, there is no federal role. The result is that states can be, and have been, as parochial or non-parochial as they choose in making siting decisions. In the old era of vertically integrated monopolies, the lack of regional or federal siting authority, while occasionally problematic, was not a terribly important matter. In the evolving world of competitive, regional and inter-regional electricity markets, regional transmission organizations, and robust competition that does not respect state boundaries, the ability of a single state to veto the construction of a new transmission facility may be an intolerable institutional barrier to the evolution of the market. The problematic nature of the institutional arrangements is reinforced by the often parochial standards employed by states, and by the fact that in many jurisdictions, transmission investment is still included in retail rate base. When a utility seeks to build transmission facilities in a state which has a siting agency (many states do not), it seeks to both establish an economic need to justify the facility and proposes to meet that need in such a fashion that the environmental, aesthetic and other impacts will be minimized. The problem is that in many states, the "need" determination is focused on the domestic need within the borders of the state. In fact, only one or two states even statutorily recognize extra-territorial or regional need as sufficient justification. Moreover, in almost every state, when a utility builds a transmission facility it seeks to put that investment in retail rate base. Thus, the siting authorities examining an application are almost always looking for an in state "need" for the facility as well as contemplating placing an increased economic burden on the state's consumers in the form of either increased rates, or the risk of bearing increased residual revenue responsibilities. The incentive to be parochial is quite compelling. Indeed, for incumbents who fear competition, the opportunity to exploit parochialism may prove irresistible. While it is neither fair nor accurate to suggest that the states have always been parochial in exercising their siting authority, in the context of the emergence of strong regional electricity markets, it is simply no longer acceptable to rely on the willingness and ability of siting officials, state courts, and incumbent utilities to rise above institutional and economic incentives to be parochial. In that context, a multi-state compact makes eminent sense. The problem is that our experience in the United States with voluntary compacts among the states to accomplish regional objectives in a context where the environmental or other insult is relegated to one state and the bulk of the economic benefits to another, is not good. Accordingly, it would be useful if Congress added some features to H.R. 2944 to encourage states to participate fully in, and live up to the obligations associated with membership in a multi-state compact. Two possibilities come to mind. One is for the FERC to make the need determination and then leave to the states the responsibility for actually locating the facility. The second would be to give the compact states a time frame for making the siting decision, but provide the FERC with fallback jurisdiction if the compact states failed to act, or otherwise failed to live up to their statutory obligations.

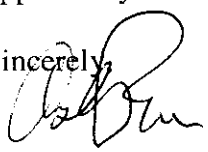
One area where the states do possess the expertise and willingness to be quite proactive and effective is in consumer protection. While it is important that the Congress provide for adequate consumer protection, it is not at all clear why H.R. 2944 proposes for the FTC to play such a critical role. It would be better to simply lay out the need for adequate consumer protection, perhaps articulate some standards and then allow the state regulators to do the job. There are very solid public policy reasons for doing so. The first is that the electricity industry is already subject to the jurisdiction of a multitude of regulatory agencies at the state and federal levels. One objective of restructuring is to rely more on market forces and less on competition. In that context, it is counter-intuitive to bring still another regulatory agency into the electricity industry. Particularly since it is not at all clear that the FTC brings any resources or expertise to the protection of electricity consumers that the state commissions do not already possess. In fact, given the extensive experience of the state regulators with consumer protection on restructuring in such other network infrastructure industries as telecommunications and natural gas, they are the repositories of much greater relevant experience and knowledge than the FTC. Most importantly, the state commissions are both closer and more accessible to consumers than the FTC. The state commissions already have the infrastructure in place to handle consumer complaints. They already have the contacts and relationships with local consumer groups, and are already regulating electricity. It simply makes sense to leave consumer protection to them, rather than muddying the waters by bringing a new regulatory jurisdiction into play. The one counterpoint to leaving consumer protection to the states might be in situations where national marketers have a legitimate need for uniformity. I am not certain that there such a need exists, but if there is, Congress can either articulate a standard of delegate to the FERC, or, perhaps even better, to a Joint Board, the authority to articulate such a standard or standards.

It is important to address the question of reliability. I think that H.R. 2944 has done an excellent job of balancing the need for industry experts to be intimately involved with the articulation of technical standards with the very compelling need for FERC to have the authority to provide the *de jure* cover that makes the standards enforceable. The absence of FERC authority has been deeply troubling to many industry participants and observers. It is important, however, to make certain that the involvement of industry experts is carefully balanced in order to make certain that no single sector or entity gains primacy in any area. The FERC will need the ability to carefully monitor the cast of characters involved. Finally, in regard to reliability, the FERC needs to have full authority to monitor such functions as control area operators and security coordinators. With RTOs, control areas, OASIS, security coordinators, and reliability coordinators, there is much opportunity for both confusion and anti-competitive mischief. It would be very useful for the FERC to have the authority to try, over time, to reduce the number of players and institutions involved in various control, coordination, and reliability functions. Consistent with maintaining high standards of reliability, the evolution of control technology, and good stewardship of bottleneck facilities and functions, the FERC should be vested with the authority to consolidate these functions into fewer and fewer institutions.

With regard to merger and market power issues, H.R. 2944 is deficient in a number of areas. The first is that the bill fails to provide the FERC with explicit authority to review horizontal mergers in generation. Horizontal mergers may well have market power or other issues that need regulatory redress. It would be good public policy to vest the FERC with explicit authority to address them. Similarly, the FERC should be given explicit authority to address and remedy wholesale market power problems. While it is true that there are other agencies with anti-trust jurisdiction, the fact is that the FERC, alone among federal agencies, is uniquely positioned to protect the public interest in regard to market power in electricity. Only the FERC has ongoing regulatory jurisdiction, and it is that ongoing role that is critical in monitoring and remedying concentrations of market power in a market that is both dynamic and instantaneous. Finally, the 180 day time line for merger decision making is ill advised. While undue delay is certainly to be avoided, arbitrary deadlines can have an adverse and unpredictable impact. The FERC may be as likely to disapprove as to approve mergers precipitously. Moreover, some merger cases are so complicated, and the due process rights of both applicants and intervenors so important, that it will prove impossible to make intelligent, fully informed decisions within the 180 day period. It would be prudent for the Congress to express its desire for expeditious processing of merger applications without mandating an arbitrary deadline.

I hope that my comments are helpful to you as you move ahead in your very important effort to enact electric restructuring legislation. Please feel free to call upon me if I can be of any additional assistance. Thank you again for affording me this opportunity.

Sincerely,



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